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The impact and the spillover effect of a sovereign rating announcement on the euro area CDS market

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A B S T R A C T

This paper analyzes the impact and the spillover effect of a sovereign rating announcement on the euro area CDS market. Through the event study technique, we demonstrate that downgrades and upgrades considerably affect financial markets. The relevance of the impact is due to the introduction of "new" information after a rating change announcement (information discovery effect) and to the role of rating in the current financial regulation (certification effect). Conversely, the CDS market does not seem to react significantly to rating warning (outlook and review) announcements. Furthermore, we find evidence of a spillover effect only after a downgrade announcement. Our results show that the size of the spillover effect is influenced by economic and financial conditions of analyzed countries and that international bank flows between EMU Members represent an important transmission channel of the spillover effect.

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1. Introduction

After the beginning of the 2007 financial crisis, sovereign ratings issued by credit rating agencies (CRAs) attracted an increasing attention from media, public opinion and sometimes also from European prosecutors (Financial Times, 2015). Rating agencies, in fact, have acquired a leading role in financial

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markets. Since the original work of Cantor and Packer (1996) until few years ago, researchers have paid particular attention to developing countries' ratings. Financial crises have rarely involved developed countries' public debt in past decades (Reinhart, 2010). But with the intense risk shift observed after the 2007 financial crisis, a greater attention has also been given to developed countries' creditworthiness, especially to euro area financial stability.

This paper aims to analyze the impact of a sovereign rating announcement on the euro zone financial markets. We measure the impact observing the reaction of the euro area credit default swaps (CDS) market. In the first part of the paper, we employ an event study methodology to analyze the effect of a rating change on the sovereign CDS market of the changed rating issuer (event country). In the second part, we extend the analysis verifying if a rating announcement has an impact on the CDS market of other EMU countries. We adopt a modified version of the model proposed by Gande and Parsley (2005) to identify a possible spillover effect of a rating announcement.

Our contribution tries to extend the existing literature in different ways. (*i*) Numerous other papers regarding the impact of a rating announcement on the CDS market are focused on corporate sector or on developing countries, while our analysis regards euro area countries. (*ii*) Böninghausen and Zabel (2015) pointed out that the results of different event studies are not easily comparable because they do not focus on specific regional crises and on homogeneous samples. Our dataset, instead, comprehends a sample of countries which share similar political and economic fundamentals, as the same currency, and which were affected by a dramatic financial crisis during the considered time interval. (*iii*) Carrying out the event study, we estimate the *AR* (abnormal returns) using the market model method, in order to control for possible systematic factors that could influence the CDS market simultaneously. To the best of our knowledge, we are the first to use this methodology examining the sovereign CDS market. (*iv*) We do not just estimate the credit rating impact on the sovereign CDS market but we test empirically three main theoretical approaches proposed in literature (described in Section 2) regarding how CRAs affect financial markets. In particular, we show that rating changes have a substantial impact on the sovereign CDS market, and part of this effect is due to regulatory constraints related to ratings. (*v*) We find evidence of a significant spillover effect of downgrade announcements on the euro area CDS market. This result holds also using different methods, such as the counterfactual identification strategy proposed by Böninghausen and Zabel (2015) (see Section 6). (*vi*) We extend previous analyses proposed in literature regarding the spillover effect of a rating announcement identifying international bank flows as a main transmission channel of the spillover effect.

The remaining part of this paper is organized as follows. In Section 2, we review the related literature and present research hypotheses. Section 3 describes the dataset. Section 4 presents the event study methodology and summarizes the empirical results concerning the impact of a rating announcement on the CDS market. A discussion regarding spillover effect and the related results follows in Section 5. Section 6 contains robustness checks. Section 7 concludes.

2. Review of related research and hypotheses

The literature has identified at least three distinct ways through which CRAs can affect financial markets (Kiff et al., 2012): (*i*) information discovery effect, (*ii*) monitoring effect, and (*iii*) certification (or license) effect. According to the first approach, CRAs produce and offer "new" information to market, relevant for the bond and other financial instruments pricing process. The market reaction observed after a rating change could reflect a possible CRAs' informational advantage. The second approach focuses on the role of CRAs as monitors of valuable coordination of beliefs in situations where multiple equilibria can be obtained (Boot et al., 2006). According to the monitoring effect theory, CRAs derive their value mainly from their monitoring role, which is put in place especially when they start credit watch procedures. The last theory, concerning the certification effect, is focused on the role of rating in financial regulation.

Several papers tried to find evidence of information discovery effect analyzing the financial markets' reaction to a rating announcement. The results have been often contradictory. As regards the stock market, Holthausen and Leftwich (1986) and Pinches and Singleton (1978) showed that the market anticipates upgrade and downgrade announcements. Brooks et al. (2004), Hand et al. (1992), and Imbierowicz and Wahrenburg (2009), conversely, estimated that only downgrades affect the stock market.

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